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What the country was struggling with [in the 1930s] appeared to be not a shortage of money, but a shrinkage of values and a general loss of confidence in banks, in business prospects and in continued employment

— *American Monetary Policy,* E.A. Goldenweiser
McGraw-Hill Book Co., Inc., 1950

Denial

The Fed's three interest rate cuts have worked wonders for global stock markets. For his swift action, Mr. Greenspan has gathered a lot of downright praise completely devoid of any critical reflection. We think important negative aspects should not be overlooked. Inarguably, the Fed is being held captive to a highly leveraged financial system. As it lurched toward collapse, a desperate Greenspan set a course to perpetuate the great American bubble. What resulted was a stunning money and credit expansion, reflecting a massive monetization of leveraged assets.

In the United States, in particular, there is a widespread, uncommon confidence in the magic of cheap money to solve all economic problems. It has, indeed, effectively overcome all previous postwar recessions. But they were different. Those recessions had been triggered by monetary tightening in response to rising inflation rates. The current global financial and economic crisis has unfolded despite falling inflation and falling interest rates. It has fundamentally different causes than tight money and will not be undone by a few interest rate cuts.

As we have repeatedly stressed, the present crisis, spreading around the world, has a lot in common with the global crisis that developed in the early 1930s. That crisis reflected the bursting of a global credit bubble. Then, as today, excess credit had led to excess capital spending, excess consumption and excess debt.

Realizing the parallels between the 1930s and today, we took a close look in this letter at the events in the year that ushered in the Great Depression—and found valuable clues.

While a stock market rally was in order after this summer's significant selloff, we must admit to being stunned by what has developed. Still, in hindsight an explanation is not so difficult to fathom. There has been tremendous money and credit creation in confluence with powerful technical factors at play. Today's markets are dominated by sophisticated derivative trading for speculation, hedges, and aggressive hedge fund shorting. Much of the recent buying likely emanates from unwinding these derivative strategies and panicky short covering. But keep in mind, this rally is a great deception. Nothing has changed regarding the underlying global environment with its deflationary forces working to slow economic growth and destroy corporate profits.

OMINOUS PARALLELS 1929/30–1998/99

Watching the beginning recovery in stock prices, we conjectured in the last letter that there is obviously more surprise and confusion than worry about the economic situation and outlook. We suspect that this prevailing complacency has two reasons. One is a massive ignorance of the deeper causes and the severity of this global crisis. The other one is a widespread simplistic belief in the power of central banks to prevent any serious recession, stock market crash or financial crisis. The latter view, we hasten to add, is popular only among American economists.

Many say, "But today's conditions—declining inflation and lower interest rates—do not at all resemble those prior to past recessions which all started with rising inflation and rising interest rates." Our response to that litany is, "Of course, they don't!" The impending economic crisis is not a typical cyclical recession. It is the upshot of tremendous financial and economic imbalances that have accumulated over the past years. *A global credit bubble, of which the financial markets were the primary and main recipient, is bursting.* This has, indeed, no parallel in the whole postwar period. To find a comparable experience, it is necessary to go back to the financial excesses of the 1920s and their aftermath.

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The parallels between the two periods are truly astonishing. The development during the last years preceding the crisis of 1929-32 were characterized by three outstanding features that have been equally predominant in the last three or four years: (1) a rampant, actually unprecedented, credit expansion; (2) heavy involvement of the banks in the securities markets; and (3) an unusually heavy reliance on securities issuance as a source of finance.

The last of these three features is generally unappreciated. Yet it is most important because securities carry one specific risk that bank loans don't—an interest rate risk affecting their market values. In other words, the risk of asset depreciation. What ravaged the U.S. banking system in the 1930s and led to the sequence of banking panics was not the stock market crash of October-November 1929, nor even an excess of bad loans. It was soaring interest spreads, which hammered the value of the lower-grade bonds filling the banks' portfolios.

This leads us to another pivotal parallel between the late 1920s and the late 1990s—a complete disconnect between available savings and credit growth. In the 1920s, the flow of funds came overwhelmingly from credit creation through the banking system. This money fueled the financial boom through huge bond purchases for the banks' own accounts and soaring loans to customers on securities. In the 1990s, the credit excesses propelling the financial boom were overwhelmingly financed through national and international money markets. Thus, in both periods, the floods of money swamping the markets had nothing to do with the investment of savings. Their paramount source was unbridled money and credit creation. In essence, it all boiled down to massive financial leveraging.

As matter of fact, the rampant money and credit creation developed in the United States in the later 1920s in an abnormal and roundabout process. On one hand, the banks were faced with mounting central bank reserves, which they naturally desired to put to earning use. But they were also faced with extremely sluggish commercial credit demand because businesses were resorting instead to stock and bond financing. Essentially, they had to look for alternative profitable outlets for their abundant reserves. They found them in two unconventional areas, toward which they aggressively shifted their lending in the following years: real estate and securities markets.

A BANK-FINANCED BOOM

The banks in the 1920s excelled at glutting the securities markets, and not just through investments for their own account. "Loans on securities" to their customers soared as well. While the banks' own investments went largely into higher-yielding, lower-grade bonds, the loans to customers were largely connected with stock

market speculation. Over the whole of the 1920s, from 1921 to 1929, no less than 84 percent of the total bank credit expansion went into these two categories, deluging the securities markets. (By the way, these figures do not include the broker loans financed outside the banking system through the call money market.)

The mystery of the Crash of 1929 and the Depression of the 1930s is that they hit so much harder in America than elsewhere. Why should the most powerful economy in the world have suffered so much more than the rest of the world? The stereotype answer of the Austrian school is that the exceptional severity of the U.S. Depression was caused by the extraordinary financial excesses and attendant economic maladjustments that preceded it. U.S. corporations depended for their financing on the securities markets, but these, in turn, depended on overabundant bank credit.

The floods of money, which the banks pumped into the securities markets, imbalanced the American financial system in four distinct ways: first, by creating money vastly in excess of the requirements for economic activity, the banks fueled the financial boom. Second, the resulting excess flows essentially forced the prices of bonds upward and, conversely, artificially lowered the long-term market rate of interest, making it increasingly profitable for businesses to float bonds and stocks. Third, these flows caused an unwarranted, sharp compression of interest spreads, as the bank investments were heavily weighted toward higher-yielding, lower-grade bonds. Finally, bank balance sheets became overloaded with illiquid bonds.

Under the influence of Milton Friedman and the monetarists, it has become the conventional view in America that the Great Depression of the 1930s had its chief cause in the failure of Federal Reserve System to maintain the money supply. To quote Friedman from *The Monetary History of the United States 1867-1960:*

> An initial mild decline in the money stock from 1929 to 1930, accompanying a decline in Federal Reserve credit outstanding, was converted into a sharp decline by a wave of bank failures beginning in late 1930.
>
> The quantity of money...fell not because there were no willing borrowers—not because the horse would not drink. It fell because the Federal Reserve System forced or permitted a sharp reduction in the monetary base, because it failed to exercise the responsibilities assigned to it in the Federal Reserve Act to provide liquidity to the banking system.

In this view, which has found wide acceptance in the United States, the Depression had its proximate cause in the massive contraction of the money stock, largely related to the successive banking panics. The declared culprit, crucially responsible for this monetary disaster, is said to be the Federal Reserve which failed to prevent it, although it could have done so through looser money and, above all, through more aggressive purchases of government bonds—often described as "printing money."

Implicit to this devastating verdict about the tenure of the Federal Reserve in the 1930s are two comforting conclusions for the future: first, that money growth is exclusively determined by the central bank; and second, that a central bank has, under all circumstances, the power to increase the money supply by a desired amount. In other words, recessions are obsolete. Central banks possess the means to prevent them just by opening their money spigots.

In the public perception, the Great Depression of the 1930s was ushered in by the U.S. stock market crash that started on Oct. 24, 1929. But it is generally suspected that bad fiscal and monetary policies played the greater role in shaping the extraordinary depth and length of the following savage deflation and depression. To again quote Milton Friedman: "A sharp but not unprecedented contraction was converted into a catastrophe by bad monetary policy..."

When people speak of the Great Crash of 1929, they usually have in mind the two worst days Wall Street has ever known, Black Thursday, Oct. 24, and Black Tuesday, Oct. 29. But these two days were only the most spectacular phase of a protracted and painfully drawn-out plunge. The Dow had hit its peak of 381 on Sept. 3. From then on, the index zigzagged downward to hit its low for the year on Nov. 13 with the Dow at 198, down 48 percent from its high. In reality, though, it had long become a very thin and selective bull market. No more than about one third of the nearly 1,200 issues listed on the New York Stock Exchange had advanced at all during the year, while more than 600 stocks had already suffered substantial declines from their earlier highs. Sounds familiar, doesn't it?

FOOL'S RALLY

When the stock market's decline sharply accelerated in late October, nobody, except a few notorious bears, had an explanation. The economic data showed industrial activity to have peaked in June. Construction and automobiles had topped out in March. On October 19, the Harvard Economic Society, the leading business analysts of the day, noted that business was facing "another period of adjustment," but added that "if recession should threaten..., as is not indicated at present, there is little doubt that the Federal Reserve System would take steps to ease the money market and so check the movement." American belief in the omnipotence of the Federal Reserve has tradition.

In fact, the stock market's collapse caused more surprise and confusion at the time than worry in the business world because the U.S. economy was generally perceived to be exceedingly strong and healthy. Above all, interest rates plunged. Past stock market crashes had always been associated with a sharp rise in both the level of interest rates and the interest rate spread. For the first time ever, a panic in the stock market had been accompanied with a steep fall in interest rates. What's more, the interest rate spread had even declined to a level below those before the stock market crash, where it continued until October 1930. Nor had there been a single major bank failure as a result of the October panic, although the banks were heavily involved in the stock market.

In this light, broad economic improvement was confidently expected for the first half of 1930s. The stock market staged a sharp recovery which was to last until May 1930, with the Dow up again by 39 percent, to 275. As the rally developed, so did the feeling that the Crash had all been a ghastly mistake—an aberration. Had not the President and the leaders of business and finance, one and all assured that the economy was "fundamentally sound"? It proved a fool's rally. In May 1930, the dreaded bear market returned. By the end of the year, the market had cascaded down 60 percent from the recovery top. In the following two years, there were to follow several false dawns, each raising the hope that the bottom had been seen It came in mid-1932, after an overall plunge of the Dow by 89 percent.

SWIFT ACTION BY THE FED

What was it that contained the effects of the first leg of the stock market crash? In short, it was extremely swift action by the Fed in concert with the money center banks. In the first week of the panic, on Oct. 25, the Federal Reserve Bank of New York reduced its buying rate on acceptances from 5 1/8 percent to 5 percent. Quickly, on Nov. 1, followed the next cut to 4 percent, on November 15 to 4 percent, and on November 21 to 4 percent. As to the Fed's discount rate of 6 percent at the time, it was lowered twice in November, and then within five months further slashed to 2.5 percent, even though the economy still looked in quite good shape.

Even more striking than the swiftness of these rate cuts were the promptness and efficacy with which the financial institutions in New York met the challenge of a threatening collapse of the call-money market, the big

lending source for those who had speculated on margin. At end-September, these loans amounted to $8.5 billion. Most of the outstanding lending had at this time come from out-of-town banks and nonbanking institutions (corporations, pension funds etc.).

Unnerved by the violent break in the market, banks and lenders outside of New York rushed to liquidate their call loans to brokers, regardless of existing collateral. Execution of these calls would have spelled much greater disaster in the markets. This was foiled by the joint action of the New York Fed and banking community. Backed by special credit facilities from the Fed, the New York banks stepped into the breach. Taking over such loans, they let the frightened lenders out. In addition, the New York Fed made open market purchases. In particular the already mentioned prompt decline of the interest spread testified to the sweeping success of the Fed's operations at the time.

THE MYSTERY OF LATE 1930

The year 1930 actually had a good start. Stock prices continued their strong rally, security issues were large, signs of improvement showed in many spots. On July 9, *Business Week* gave in an article eight reasons for an impending business upturn, including the rapid rate of expansion of bank credit, low inventories, low prices for raw-material imports, and good prospects for autos in the fall. It seemed as though the crash had come and gone, without having done any serious harm to the economy. Until the middle of the year, there was no expectation of a looming economic and financial crisis. Rather, it was argued that the monetary easing ushered in by the stock market crash would promote business. While people were aware that business was slowing, they had no doubt that the economy would recover soon.

"We have never believed in the simplistic monetarist explanation of the Great Depression."

All this was to change dramatically in the second half of the year, particularly in the last quarter. Schumpeter aptly described the sudden, dramatic change in the situation and associated expectations with the following brief statement: "People, for the most part, stood their ground firmly. But that ground itself was about to give way." The prevailing slow downtrend of the economy began to accelerate, turning late in the year into a broad, vicious plunge. All of a sudden, everything was collapsing against the background of the first wave of bank failures. The Dow ended the year at 157, down 59 percent from its September 1929 peak and 43 percent from its recovery top in May 1930.

What caused this sudden, dramatic deterioration of the economy? That's the big, hotly disputed question. For American monetarists, the answer is simple and straightforward: In their eyes, the one and only culprit was the Federal Reserve because it had failed to prevent the banking crisis in November–December which had precipitated the sharp decline in the economy as a whole through its fatal effect of contracting the money supply. In the monetarist concept, the one and only thing that crucially matters for economic growth is money growth.

For sure, the banking crisis of late 1930 was a notable feature of the sudden collapse. But was it cause or effect? Did the U.S. economy collapse because of the banking crisis or, conversely, did the banking crisis happen because the economy collapsed? This is the most important question concerning that period because the answer is of the highest relevance for the present. Historic experience strongly suggests that **financial crises always occur after the onset of recession**, which appears to us plausible and logical.

We have never believed in the simplistic monetarist explanation of the Great Depression. First of all, we disagree with the whole money supply concept, considering credit growth, rather than money growth, as the

crucial variable. But scrutinizing the development in the 1930s, two observations in particular put us at loggerheads with the monetarist view: first, the decline in the economy preceded the decline in the money supply; and second, nominal gross national product—resulting from plummeting prices as well as from plummeting output—fell considerably faster than the money supply. As a percentage of GDP, the U.S. money stock did rapidly rise after the 1929 stock market crash. Here the figures:

Year	**U.S. Gross national product,** *billions of $*	**Deposits and currency** *billions of $*	**Deposits and currency** *as percent of GNP*
1926	92.3	50.3	54.5
1927	90.4	52.0	57.5
1928	93.7	54.4	58.1
1929	99.4	54.8	55.1
1930	90.9	54.1	59.5
1931	75.9	52.4	69.0
1932	58.3	45.0	77.2
1933	55.8	40.8	73.1
1934	64.9	44.2	68.1

Sources: Department of Commerce; Federal Reserve; American Monetary Policy, E.A. Goldenweiser, McGraw-Hill Book Co., 1950

Yet very few American economists have refuted the monetarist explanation of the Great Depression. Best-known among them is Prof. Peter Temin, Massachusetts Institute of Technology. He stresses an exceptionally steep fall of consumer spending in 1930, equal to 3 percent of GDP, as the decisive, distinguishing feature of the unfolding economic downturn, aborting the recovery and perpetuating the downturn. But he admits that the source of this difference is unclear. In the same vein, he complains of an oversupply of housing and of overcapacity in many areas.

BOOM—BUST

This is, of course, the point where Austrian theory comes in with its well-known postulate: It is the excesses during the boom that set the stage for the dramatic retrenchment that takes place when the bubble pops. What had actually happened in the 1920s was that construction and business capital spending had already stalled in 1926–27. Essentially, this ought to have curtailed consumer income and spending growth. Instead, however, there developed an unprecedented consumer spending boom, accounting in the following years until 1929 for the whole of the U.S. economy's growth. The only available explanation of this accelerating consumer spending binge was the accelerating stock market boom with its attendant but ephemeral profits. Certainly not by accident, consumption was to account in the following years for an unusually high share of the GDP contraction.

Sounds familiar, too, doesn't it? Over the last three or four years, consumer spending has risen almost twice as fast as income, as capital gains have encouraged households to run down past and present savings. The

most striking evidence of why this cannot last is the plunge in the personal savings ratio into negative territory. Corporate America has also been on a borrowing and spending binge, as investment has far outstripped cash flow. Investment and consumption by the private sector have recently exceeded current income by more than 4 percent of GDP. Never before has this excess of spending over income been greater than 1.4 percent of GDP. Its striking counterpart is the soaring U.S. current-account deficit. This mammoth deficit, by the way, essentially

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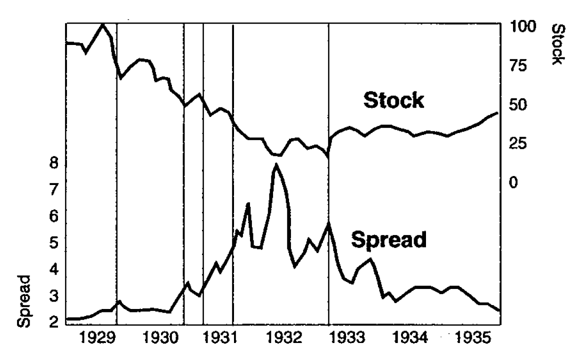
implies that the U.S. economy is far more out of balance today than in the 1930s. At that time, the United States was the greatest creditor country in the world with a chronic credit surplus. Actually, it was the strong balance of payments that gave the Fed the free rein for its swift rate cuts which nevertheless failed to revive the economy. With the U.S. trade balance now deep in the red, Mr. Greenspan would definitely not enjoy this freedom of action

To continue this story: The unexpected, rapid weakening of the economy later in 1930 triggered growing anxiety in the financial sphere. This was initially reflected in the plunging stock prices and rising interest rate spreads. But while the economic crisis had been developing for several months, the banking crisis struck late in the year, in November–December.

Stock prices and the interest rate spread



Another aspect of the following sequence of the banking panics, widely overlooked, is that these originated in reality in the disruption of the securities markets. The wholesale destruction of bank credit and bank deposits during the Depression in America did not come about through bad loans but through capital losses from the collapsing the market values of lower-grade bonds, which the banks held en masse. This effect was also exhibited in soaring interest rate spreads. By the middle of 1932, the spread between interest rates on corporate Baa-rated bonds and Treasury bonds had surged to above 7.5 percent, more then three times their level before October 1930. This contagion through the securities markets, by the way, also explains the speed with which the banking system reacted to bad economic news, as capital losses took place instantly.

THE WORLD'S BIGGEST WORRY: THE U.S. ECONOMY

Why have we gone so scrupulously into the U.S. economic development in 1930? In short, because we see important parallels between then and today and expect a similar pattern of economic performance of the U.S. economy next year as in 1930. The decisive parallel is essentially in what happened during the boom.

In 1927-29, the U.S. economy degenerated into a "bubble economy." Easy credit and soaring share prices sent businesses and consumers on a frenzied spending spree. The favorable short-term result was a booming economy, but the longer-term result was economic depression, as the bursting bubble forced businesses and consumers to drastic, prolonged retrenchment. The U.S. economy's extraordinary boom since 1995 has

displayed exactly the same characteristics of a bubble economy as the late 1920s economy, resulting equally in excess capacity and protracted overconsumption. These excesses in both fields leave America's economy vulnerable to the worst recession since World War II. The biggest worry for the world economy now lies not in Asia or Latin America but in the U.S. economy and its financial system. When they finally break, the world is in trouble, particularly share markets. We said when, not if.

Perhaps, we are very much alone in expressing ourselves so distinctly that the dangerous dislocations in the U.S. economy, boding ill for the future. Yet, we note that leading economists even on Wall Street are basically in line with our thinking, though exercising great caution in expressing conclusions that may shock the stock market. The frankest and most pertinent comment from Wall Street in this respect that we have so far encountered, published in *The New York Times,* came from Charles Clough, chief investment strategist of Merrill Lynch. We can't resist letting him speak for us:

> Is all this merely fallout from Asia's troubles, or are there domestic problems that may need working out?
>
> There is evidence that overinvestment, widely seen as the basic cause of Asia's fall from economic grace, could be a problem for the U.S. economy as well. Simply put, excess capacity for everything from steel to semiconductors suddenly emerged on the Asian landscape. Could Asia's problems be developing in America perhaps in miniature?
>
> Immense amounts of capital have been available in the last few years. American businesses became more efficient and generated huge amounts of free cash. The have used that cash to finance one of the greatest investment booms ever. Investment has grown 70 percent faster than final sales during the past three years. It has been the engine that has produced jobs and growth.
>
> There is a downside, however. Investment increases production capacity, and now excess supplies are proliferating ...
>
> Retailers and financial institutions have added capacity faster than Americans can either spend or save ...Telephone service providers have multiplied as local phone companies vie with long-distance suppliers ... to build telephone systems ...
>
> In reasonable amounts, investment is healthy. It enhances productivity and profits. But, like anything else, there can be too much of it. Excess capacity eventually drives down prices and profits begin to suffer.
>
> For much of the recent expansion, business could finance capital expansion, cover dividends and have cash left over. Ominously, in 1997 that began to change. Heavily committed to capital spending, businesses began to hemorrhage cash, and many must now borrow heavily to plug the deficit. Since 1996, nonfinancial corporations have doubled the amount of new bonds they are issuing, to $ 360 billion annually.
>
> Suddenly there are business risks, quality risks, liquidity risks, a kaleidoscope of risks never faced by a buyer of Treasuries.

For the sake of completeness, however, we hasten to add that Mr. Clough has put his finger only on one bubble feature in the U.S. economy: overinvestment and excess capacity. The other one, no less important and perilous, is the unsustainable consumer spending boom, artificially fueled by the stock market wealth effects.

ECONOMY, STUPID

In the global stock markets, it appears, the bulls haven taken over again. In particular in Asia, except Japan, the markets have staged stunning recoveries of 50 percent and more. Still, we wouldn't waste any time on attempts to rationalize these rallies. They are regular features of bear markets. Just think of the big U.S. stock rally in 1929–30 immediately after the Crash. Yet, the sharp recoveries certainly reflect at least partly a general complacency about the financial crisis coupled with a widespread belief that, if push comes to shove, the Federal Reserve will resort to most aggressive easing—saving the situation again.

Briefly back to 1930 and the question of what it was that broke the U.S. economy and made the depression so much worse than usual. According to the monetarists, the culprit was monetary stringency, fostered or allowed by the Fed. However, money became cheaper and cheaper. The call-money rate, which ranged from 4.5 percent to 6 percent in January 1930, had dropped to 2 percent by the end of July, and remained at approximately that level until year-end. No less remarkable was the stabilization of the interest spread. Actually, a significant decline in the money stock did not start before March 1931. In this light, the Fed had done a magnificent job in stabilizing the financial sphere after the Crash. But while the cheap money magic still worked in the financial markets, the jaded economic organism no longer responded.

How can there be depression without monetary stringency? Very simple: Principally, there are two potential causes, which both came in 1930 and following years forcefully into play: first, debt deflation as the inevitable aftermath of the earlier debt excesses; second, inevitable painful readjustment processes in the economy's output structure necessitated by boom-related maladjustments. Against these powerful depressing forces, the Fed's easing was just a feeble candle. In the course of the year, the economy collapsed.

In short, the key point to see about 1930 is that the Fed was temporarily successful in stabilizing the financial sector but that it miserably failed to revive the badly maladjusted economy. This is in our view precisely the pattern we have to expect in 1999 and following years. To repeat: Financial panics always occur after the onset of a recession.

On the surface, the U.S. economy did look fine in the third quarter of this year. GDP growth was stronger than expected. But the two forward-looking components, fixed investments and profits, declined for the first time since 1991, a recession year. Corporate profits were down 6.2 percent from their corresponding level a year ago. The bulls like to believe that the stock market does forecast economic activity better than anything else. Forget it. Look at profits as the key determinant of capital spending which, in turn, is the key variable, driving economic growth both from the demand side and the supply side. Even though the sales for Corporate America were up 7 percent in the third quarter, profits have dropped sharply. This, clearly, spells a profit disaster, when the economy slows. One of the most striking features of the development in 1930, by the way, was a virtual profit collapse. Be prepared for the same in 1999.

Considering that this profit crunch has been developing against the background of continuing strong economic growth, the main culprit must essentially be lack of pricing power. As companies will curtail their investment spending, corporate pricing power and profits will further diminish—setting the stage for a prolonged economic and financial crisis even in the face of falling interest rates.

THE TRUTH: A CREDIT EXPLOSION

As long as the stock market kept booming, it was the general view, apparently shared by Mr. Greenspan, that the Fed should not interfere with market forces. But as soon as a crash began to threaten, everybody yelled

for instant and drastic action by the Fed to counter it. And the Fed promptly obliged.

Obviously, it was not economic weakness but financial trouble that induced Mr. Greenspan's precipitate rate reductions. The official explanation for the reductions—readily accepted—is that the objective was to impede a developing credit crunch. It seemed a legitimate purpose for monetary policy, and it conveniently refuted any misgivings that Mr. Greenspan had acted in order to reflate the stock market bubble. But what exactly was the evidence for an effective credit crunch, threatening to strangle U.S. economic growth? Looking for such evidence, we discover nothing but rampant credit excess. Despite well-publicized difficulties at some overleveraged hedge funds, the banking system has been expanding at a record rate.

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We think Mr. Greenspan's true purpose was to bail out Wall Street. While exorbitant credit growth has been carelessly disregarded for some time, recent data show truly unprecedented excess. For the month of October, total bank credit expanded at a stunning annual rate of 22 percent. Importantly, almost half of this growth was in security purchases. Bank holdings of non-U.S. government securities surged $37 billion, or at an annual rate surpassing 100 percent. Taking up the slack from faltering securities markets, banks were also aggressive lenders as commercial and industrial loans soared at an annual rate of 27 percent. Interestingly, with bank credit exploding by almost $100 billion during October, bank deposits increased but $23 billion. The huge gap between bank credit and deposit growth was filled by "Borrowings from banks and others." We point attention to unbridled credit creation by the banking system reminiscent of the roundabout process in the 1920s mentioned previously.

THE OTHER FOUNTAIN HEAD: MONEY MARKETS

While occasionally some note is taken of the flood of bank credit, there is an almost complete lack of recognition of the role money markets play presently. Government bonds held by dealers and financed by money market repos rose between end-1996 and end-1997 from $960 billion to about $1.1 trillion, and stood at over $1.5 trillion in May 1998. Money market fund assets now approach $1.4 trillion, having grown $300 billion, or almost 30 percent, during the past year. In fact, the explosion of money market funds largely explains the excessive growth in the monetary aggregates, especially over the past several months as M3 money supply has grown at an annual rate of more than 13%.

For the three-month period of August through October 1998, M3 money growth reached astonishing $200 billion (fully 60% greater than the same three-month period in 1997!). Almost 70% of this growth can be traced directly to an explosion of money-market-fund assets. To clarify, during this period currency in circulation grew by $14 billion, total checkable deposits actually declined by $400 million, savings deposits increased $53 billion, large time deposits grew $6 billion, but money fund assets ballooned $137 billion. Remarkably, and what should be setting off deafening alarm bells throughout the Federal Reserve System, this three month money fund growth compares to $50 billion during the similar period in 1997, fully 270% the level of the previous year. Clearly, if anyone is searching for an explanation for the parabolic move in the money aggregates, it lies patently with the money markets.

In this regard, we must again admit to being flabbergasted by the level of understanding that permeates the American economic and financial community with respect to the mechanisms of money and credit creation. To

this day, there is a dogmatic belief that only banks "create money and credit," with changes in bank reserves controlling bank credit and money expansion. Accordingly, traditional monetary analysis strictly focuses on changes in bank reserves and the narrow definition of money, M1, as the crucial measures of the prevailing monetary stance, while securities markets and non-bank intermediaries are regarded as institutions that merely transfer money from savers to borrowers, implying therefore no credit and money creation.

With bank reserves in the United States actually down year-over-year from $47.4 billion to $45 billion and M1 only slightly up over last six months, it is completely inconceivable to most Americans that in the face of such tightness in bank reserves and narrow money there could be a virtual explosion of credit and the broad money aggregates. The answer is very simple: there is more and more financial leverage in the financial system on the basis of existing cash balances through the explosive growth of securitization. Asset-backed securities markets, totaling $3.7 trillion at present, are rapidly overtaking the banking system, totaling $4.3 trillion, as a credit source.

GREENSPAN'S VIGOROUS PARTNERS—FANNIE AND FREDDIE

As a matter of fact, it has long been recognized that non-bank financial intermediaries can also **create** credit without regard to available savings. But they create different kinds of liabilities. In the United States, the soaring credit creation outside the banking system is largely reflected in the money market funds, being counted as broad money components.

In past letters, we have repeatedly drawn attention to the rampant expansion of the two government-sponsored institutions dominating the mortgage market—Fannie Mae and Freddie Mac—securing through their borrowing and lending uninterrupted, huge flows of funds into the mortgage market. Clearly, they also played a key role in stabilizing the markets during this past tumultuous October. While parts of the highly leveraged institutions of the U.S. financial system stood on the brink, massive credit expansion by the banking sector, as earlier described, and by Fannie and Freddie have come to the rescue for now.

In a key development, despite dramatically wider credit spreads and considerable tumult throughout the mortgage-backed securities marketplace, Fannie and Freddie, nonetheless sharply lowered consumer mortgages to as little as 6.49 percent in early October, the lowest rate in decades. This quickly incited record mortgage refinancings, providing Fannie and Freddie with a huge pool of new mortgages, ballooning their balance sheets.

In October alone, the two purchased no less than $26 billion of mortgages for their own balance sheets, by far an all-time monthly record and fully 400 percent the volume of October 1997 purchases. Indeed, their assets expanded during the month at an annual rate of 52 percent and, not surprisingly, money fund assets also experienced a momentous month, expanding at a 63 percent annualized rate. Unquestionably, this effort of Freddie and Fannie played a powerful role in reliquifying the credit markets.

Freddie and Fannie borrowed aggressively from the money markets to absorb the flood of mortgage financing. This operation was a godsend as much-needed cash was directed to leveraged holders of mortgage-backed securities who could use this liquidity to reduce their leverage or purchase other credit market instruments. In addition, Fannie and Freddie forcefully expanded purchases of loans and securities having financed commercial real estate, multifamily, home equity, subprime and manufactured housing, much explaining the celebrated contraction in credit spreads. Mr. Greenspan had vigorous and most important partners in Fannie and Freddie.

The Fed appears to be adopting the reliquification of the credit markets as the overriding policy objective. Thus, it is fomenting truly unprecedented credit excess and financial system leverage, not to mention egregious

stock market speculation. Yesterday the reckless hedge fund and brokerage community was the leading purveyor of the American credit bubble. Now this baton has been handed to the domestic banking sector backed by deposit insurance and to Fannie and Freddie with their implied debt guarantee from the American taxpayer. After turning a blind eye to years of massive hedge fund and Wall Street leveraged speculating, allowing such to grow to both dominate and debase the entire financial system, it is appalling that the Fed is now forcefully to perpetuating this hopelessly parlous financial bubble itself. Admittedly, it has done so, so far, with much success but this only raises the stakes for the inevitable day of reckoning.

CONCLUSIONS

The Fed's trifling rate cuts have proved highly efficient in hyping global stock markets again. Yet they are not apt to prevent the further slowdown of the global economy, which has its cause not in monetary tightening but in the monetary excesses of the prior boom.

The next phase of the global economic crisis will be a major slowdown in the growth of the U.S. and the European economies, implying further rate cuts on both continents. But the Fed will act more aggressively than the European Central Bank. The interest rate differential in the dollar's favor will shrink in the coming months, if not disappear. Together with the huge trade deficit, this will make for a very weak dollar.

Economic growth in Europe has been very sluggish in comparison to that in the United States. But the U.S. economy has degenerated into a highly vulnerable bubble economy with an extremely vulnerable financial system. For good reasons, it is the Fed, and not the ECB, that lost its nerve and cut its rates in the past weeks. Ludicrously, the markets celebrate this as strength.

For the time being, the global financial crisis has been contained. It will reappear with a vengeance, once the U.S. recession will come in sight. The unfolding global crisis is the deflating of an international bubble of excess capacities, overvalued assets, and excessive debt. Against these depressing forces, interest rate cuts are no more than palliatives. Don't let yourself be fooled by the new stock market hype.

The final straw for Goldilocks will be punk profits.

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